88-1389

No. _____

In The

Supreme Court of the United States

October Term, 1988

H.J. FREEDE and JOSEPHINE W. FREEDE,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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April 25, 1989

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QUESTION PRESENTED

Whether for Federal income tax purposes amounts received by cash-basis taxpayers for excess payments under the "take or pay" provisions in a gas supply contract are to be treated as production payments within the meaning of Section 636(a) of the Internal Revenue Code or as income to the recipients.

RULE 28.1 LISTING

H.J. Freede and Josephine W. Freede

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On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners H.J. Freede and Josephine W. Freede ("Taxpayers") respectfully pray that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Tenth Circuit (Circuit Judge Ebel, with Circuit Judges Moore and Barrett), which reversed a judgment for the Taxpayers based on a United States Tax Court decision.

OPINIONS BELOW

The opinion delivered in the Court of Appeals is reported at 864 F.2d 671 (10th Cir. 1988).

JURISDICTION

The judgment of the Court of Appeals was dated and entered November 1, 1988. Petitioners' timely petition for rehearing and suggestion for rehearing en banc was denied by the Court of Appeals on January 27, 1989. The panel judges, upon their own motion, revised their opinion in the same order. Robert S. Folsom and Mary M. Folsom, petitioners below in No. 86-2403, do not join in this petition for writ. The jurisdiction of this Court to review the judgment of the Court of Appeals by writ of certiorari is conferred by 28 U.S.C. §§1254(1), 2101(c).

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

26 U.S.C. §636(a) and 26 C.F.R. 1.636-3(a).

STATEMENT OF THE CASE

This case involves the proper treatment for federal income tax purposes of amounts received by the Taxpayers from Oklahoma Gas and Electric Company ("OG&E") under a "take or pay" provision in a gas supply contract for gas not taken by OG&E during the

year in question. Taxpayers own fractional working interests in various oil and gas leases in Oklahoma. In 1976, they entered into a take or pay gas purchase contract with OG&E. Under this contract, OG&E agreed to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the take or pay provision exceeded the amount of gas actually taken from Taxpayers' well, OG&E had the right to credit the excess amount in later years against gas taken in excess of the minimum contract quantity. However, OG&E would lose the benefit from any excess payments that it did not recoup by taking extra gas within the twenty-year term of the contract.

In 1979, OG&E made the minimum payment required by the contract but took less than the minimum contract quantity. Thus, a portion of the contractual payments that Taxpayers received from OG&E in 1979 represented payment for gas not actually taken in that year. At that time, the leases had sufficient projected reserves to enable OG&E to recoup the untaken gas in later years if it wanted to do so.

Although Taxpayers were on the cash, as opposed to accrual, method of accounting, they did not include as income the amounts received in 1979 for gas not taken that year. They maintained that OG&E's excess payments created "production payments" pursuant to I.R.C. §636(a), 26 U.S.C. §636(a), and therefore the payments should be treated for income tax purposes as if they were loans, with income recognized only when the gas was actually delivered in subsequent years.

A. The Trial Court Proceedings.

The United States Tax Court, in a decision reviewed by the full Court, held that the excess payments created production payments within the meaning of Section 636(a) and therefore should be treated as nontaxable loans with income recognized only when the gas was actually delivered.

B. The Court of Appeals Decision.

The Tenth Circuit Court of Appeals reversed the decision of the Tax Court on the basis that OG&E's recoupment rights under the take or pay contract did not give rise to an economic interest in the gas in place sufficient to amount to a production payment for Section 636(a) purposes. This conclusion was reached because the Court determined that OG&E had not made any investment in the gas-producing enterprise and did not look to income derived solely from extraction of the mineral for the return of any investment. The Court concluded that OG&E's interest was an "economic advantage" rather than an "economic interest" in the minerals in place. The Court also discussed the first prong of this Court's test in *Palmer v. Bender*, 287 U.S. 551 (1933), but concluded that its analysis did not lead it to a clear conclusion as to whether OG&E had an interest in minerals in place.

Petitioners' motion for a hearing en banc was overruled. This Petition involves questions concerning the application of the doctrine of economic interest as previously set forth by this Court.

REASONS FOR GRANTING THE WRIT

I.

THE COURT OF APPEALS IMPROPERLY APPLIED THE DOCTRINE OF ECONOMIC INTEREST, AS PREVIOUSLY ESTABLISHED BY DECISIONS OF THIS COURT, TO TAKE OR PAY PAYMENTS

The Tax Court below concluded that the excess payments made by OG&E to the Taxpayers created production payments. The only Tax Court conclusion which was challenged on appeal is whether or not the recoupment rights (the phase "recoupment rights" is the panel's language; Taxpayers would use the phrase "interest in property") constituted an "economic interest." The Tax Court found, and the Commissioner did not challenge, that the other requirements for treating the recoupment rights as production payments are present. Thus, this case revolves around the application of the economic interest doctrine to take or pay payments.

Section 636(a) was added to the Internal Revenue Code of 1954 ("Code") in 1969 to treat production payments as mortgage loans and not as economic interests. One of the requirements for this treatment *not* to be *treated* as an economic interest was that it actually be an economic interest! The change of law was merely the treatment of the production payment, not the test. The test was set forth by this Court long before 1969. Prior to the enactment of the Tax Reform Act of 1969, a production payment was both an economic interest and was so treated for tax purposes. After the Tax Reform Act of 1969, a production payment did not cease being an

economic interest, Section 636(a) merely changed its treatment for tax purposes.

Section 636(a) defines a production payment as follows:

> "A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property."

The regulations, 26 C.F.R. §1.636-3(a)(1) provide in part:

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in the mineral in place. It may burden more than one mineral property, and the burdened property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments".

> (b) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of Section 636 and the regulations hereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. . . .

OG&E's recoupment rights pursuant to its contract with the Taxpayers are the economic equivalent of a production payment and therefore should be so treated in accordance with the Regulations.

The Code Section and regulations cited above derive from the two-prong test first set out by this Court in *Palmer* for determining whether an economic interest is present. That test is: (1) there must be an interest, acquired by capital investment, in the minerals in place and (2) the return of the investment must be realized solely from the extraction of the minerals. See *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 314 (1956). Both prongs of the test are satisfied in the take or pay situation.

A.

If Allowed to Stand, This Decision is in Conflict With Prior Decisions of This Court Since It Improperly Applies This Court's Doctrine of "Economic Advantage" to Take or Pay Contracts.

The Court of Appeals' finding that OG&E does not have an interest in the gas-producing enterprise and does not look to income derived solely from extraction of the

mineral for the return of its investment, thereby making OG&E's interest an "economic advantage" rather than an "economic interest," is erroneous.

OG&E clearly has an interest in the well. If the well developed mechanical problems and could no longer produce, OG&E would lose the ability to produce the minerals it paid for earlier; it would lose its interest in the well. This is not the case in any of the cases which have found an economic advantage rather than an economic interest. See *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965); *Rissler & McMurry Co. v. United States*, 480 F.2d 684 (10th Cir. 1973); and *Utah Salt Co. v. Wise*, 370 F.2d 976 (10th Cir. 1967).

In all of these economic advantage cases, the party incorrectly claiming it had an economic interest lost nothing if the well ceased producing (other than the possibility of making a future profit). These parties' only investment was in the form of equipment to be used for the processing of wet gas, salt, etc. None of the parties had one cent invested in the mineral deposit. Here the total amount of money which OG&E invested was invested in the gas. The very nature of a production payment is that the investment be solely in the mineral. This is an interest in the well.

Commencing with *Bankline*, this Court has required the finding of a capital investment in the mineral deposit by one claiming it possessed an economic interest. OG&E bought the gas from the Taxpayers when it paid the Taxpayers; it parted with its capital at that time. The only thing OG&E received was a right to the mineral deposit.

This payment by OG&E was the required capital investment in the mineral deposit.

The recoupment rights possess all of the characteristics of a production payment. Again, it is only the economic interest issue which is before the Court. The Commissioner has agreed below that the other four characteristics of a production payment are present. An excellent discussion of the characteristics of a production payment can be found in *Standard Oil Company of Texas v. Marshall*, 265 F.2d 46 (5th Cir. 1959):

> " . . . an oil payment is not a conveyance of oil in place, not a promise to pay money, not a contract for sale of oil after production but an incorporeal hereditament in the nature of an overriding royalty creating a present interest in land.
>
> * * *
>
> An oil payment is like an overriding royalty. It is carved out of the lessee's share of the oil, the working interest, as distinguished from the lessor's royalty interest. It differs from an overriding royalty only in that it is of limited duration; it expires when the payor receives a fixed amount from his interest." (265 F.2d at 53, footnote omitted.)

The recoupment rights were carved out of Taxpayer's working interest, and they expire when OG&E receives a fixed amount for their interest. The recoupments rights give OG&E an interest in the mineral.

Under Oklahoma law, an agreement to exchange a production payment for services has been held to be within the statute of frauds indicating that a production payment is an interest in land. *Dille v. Carter Oil Co.*, 192 F.2d 791 (10th Cir. 1951); see also Kuntz, *The Law of Oil and Gas*, Vol. 5, ¶63.3.

The Tenth Circuit stated (at 16-APP) that the excess payments do not entitle OG&E to "anything more than an amount of gas in subsequent years equivalent to that paid for but not taken in earlier years." This is exactly the nature of OG&E's investment. It paid money currently (its investment) to Taxpayers so that it could ensure itself a supply of gas in the future. Since gas cannot be stored, OG&E made a current investment so that its needs can be met in the future.

The Commissioner's *official* position on the proper characterization of the inverest involved in a take or pay situation is directly contrary to what he argued in the Tax Court and to what the Tenth Circuit held. In Revenue Ruling 66-64, 1966-1 C.B. 97, the Commissioner held, in a take or pay situation exactly like the one in this case (title did not pass until production, etc.) that:

> "It is clear that the cost of gas purchased for resale and taken during the contract year in which liability for the payment was incurred gives rise to the acquisition of an asset. Similarly, the fact that the taxpayer defers the taking of all or any portion of the gas until a contract year subsequent to that in which the failure to take the specified quantity of gas contracted for occurred does not alter the nature of that which was acquired by the payment for such gas – *viz*, an asset with an ascertainable fair market value."

Taxpayers could not have stated this any better than the Commissioner. As the Commissioner properly proclaimed in the Revenue Ruling, the payment by OG&E did result in investment in an asset. OG&E acquired an economic interest not a mere economic advantage.

For some reason the Tenth Circuit stated in its opinion (14-APP) that OG&E "certainly does not look to

income derived solely from extraction of the mineral for the return of any investment." As the Tax Court found below, OG&E had nothing else to look to for its return than the income derived from extraction of the gas.

B.

The Court of Appeal's Expansion of the Requirements Necessary for an Economic Interest to Include a Profit in Addition to a Return of Investment is Inconsistent With Prior Decisions of This Court.

Another factor stated by the Court of Appeals for reversal was that OG&E is not seeking through its recoupment right a profit from the extraction of the gas. This is simply not the test set out by the Code or this Court.

As the Tenth Circuit indicated, the test for determining economic interest began with this Court's *Palmer* case. The language cited by the Tenth Circuit is:

> [The depletion statute covers] every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of oil, to which he must look for a *return of his capital*. Id. at 557. (Emphasis added.)

The criteria is the return of his capital. There is simply no requirement under *Palmer* that the holder also make a profit; he merely has to look solely to the extraction of oil for the *return* of his investment. It is not even a requirement that the full investment be returned. The importance of the test is the source of the return not the amount thereof. In the *Rissler* and *Utah Salt* cases, the Tenth

Circuit reaffirmed this Court's rule that the taxpayer must look solely to the extraction of the mineral for the return of its investment. This language, return of investment, has been constantly repeated in decisions of this Court, in the Code and in the Regulations thereunder.

Although this Court's decisions in *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), and *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 899 (1946), both have language using the word "profit" in the return of investment context, there is no decision of this Court or any other Court which requires anything more than a return of investment (capital). Both *Burton-Sutton* and *Kirby* dealt with whether a sale had taken place and arose in connection with the granting of an allowance for depletion. There is no such sale or depletion issue present here. The *Palmer* test of return of capital is the appropriate test.

It is certainly true that OG&E intends to make a profit on what it does with the gas after its extraction. This, however, should have no bearing on the issue in this case. OG&E is not in a position to argue that it has an economic interest in the gas after it converts it to electricity so that it could claim depletion on the enhanced value. That is what the taxpayers in *Bankline*, *Rissler*, and *Utah Salt* were claiming. In each situation, those parties were taking a mineral product, enhancing its value and were attempting to claim depletion on the enhanced value of the mineral. Their only investment was in the equipment they used in the production of the mineral and the only return of investment came from profits from their respective enhancement activities.

OG&E paid significant moneys for the gas. It has no investment in equipment with respect to which it needs recoupment. There is no claim that OG&E has an economic interest in the "processed" gas. It merely has an economic interest in the gas it paid for, and therefore it will be entitled to depletion in an amount equal to what it paid for the gas (which should be allowed to it as the recoupment payments are made). Thus, when OG&E's investment has been recouped there will be a concomitant amount of depletion allowed to it. Since OG&E's recoupment rights are an economic interest, the Taxpayers properly treated the excess payments by OG&E as production payments.

C.

The Determination of the Court of Appeals That OG&E's Excess Payments Cannot Properly be Viewed as Investments in the Gas Property is Inconsistent With Prior Decisions of This Court.

In discussing the first prong of the *Palmer* test, the Court of Appeals examined five factors which bear on the issue of whether OG&E has an interest in the minerals in place. The first of these was the degree of legal interest in the minerals. In making this analysis, the Court focused on the legal title to the minerals.

OG&E did not have legal title to the minerals in place at the time it entered into the contract. This Court has previously held that legal title to the minerals in place is not required for the existence of economic interest. *Commissioner v. Southwest Exploration Co.*, supra, and *Kirby Petroleum Co. v. Commissioner*, supra. The take or pay contract provided that title to the gas passed to OG&E

upon production of the gas. In fact, the Tenth Circuit has ruled that OG&E could not have title to the oil or gas in place because:

> " . . . oil and gas in natural state is not susceptible of ownership in place apart from the land in which it is found, but is personal property when reduced to possession. Whether or not title passes upon the occurrence of production must be determined from the language of the lease." *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir. 1957), at page 67.

Here OG&E's contract with Taxpayers provides that title passes to OG&E upon production. Even though this Court has found the existence of legal title not to be mandatory, if title is relevant to the consideration, title here did pass to OG&E as soon as it was legally possible to so pass.

The second factor relates to the control over the minerals. The Tax Court found OG&E had control. The Court of Appeals concluded that OG&E possessed at least "significant control".

The third factor was the extent of contribution to the development or operation of the mineral extraction. Prior to 1969, a production payment was used in the so-called ABC transactions to allow the payments of the acquisition price of oil and gas properties with pre-tax instead of after-tax dollars. For this treatment to result, the production payment had to be an economic interest. In all ABC transactions, the purchaser of the production payment never contributed to the production of the gas. It merely bought the production payment. Yet in all cases the production payment was treated as an economic interest.

Taxpayers have found no case in which the economic interest status of a production payment was questioned because it was purchased. On the other hand, the Tenth Circuit has previously held that a purchased production payment is an economic interest. *Commissioner v. I.A. O'Shaughnessy, Inc.*, 124 F.2d 33 (10th Cir. 1941). There is simply no basis for treating the lack of contribution to the development as a factor against OG&E in this context since one who acquires a production payment rarely if ever can meet this test.

The fourth factor, risk of loss, was found to be present by both the Tax Court and the Tenth Circuit.

The fifth and final factor is whether OG&E's recoupment interest in the gas is necessarily reduced as production occurs. When OG&E made its investment in the gas, there was a finite number of feet of gas recoverable from the reservoir. As each foot of gas (whether it is one to which OG&E is entitled or not) is produced, the amount of gas from which OG&E can recoup its investment is reduced. This is what is required by the fifth factor.

Thus a proper analysis of the factors constituting the first prong of the *Palmer* test indicates OG&E meets each of the four factors which can be satisfied by a production payment. Accordingly, this consideration leads to the clear conclusion that OG&E had an interest in the gas in place.

II.

ASSUMING THAT THIS COURT'S PREVIOUS DECISIONS DO NOT FORECLOSE THE DECISION OF THE COURT OF APPEALS, THE COURT OF APPEALS HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT PREVIOUSLY BEEN DECIDED, WHICH DECISION SHOULD BE MADE BY THIS COURT.

Neither counsel for either party to this action, the Tax Court nor the Tenth Circuit has cited any previously decided case dealing with the federal income tax consequences of payments made pursuant to take or pay contracts. There currently exist estimated claims to amounts due under take or pay contracts in an aggregate amount of several billion dollars, the federal income tax consequences of which are dependent upon the decision in this case.

Perhaps no other area of the federal tax law has more of its genesis in the decisions of this Court than the area of economic interest. It has been many years since this Court has needed to decide a new case in the economic interest area. The taxability of take or pay payments is an issue which is important to the entire oil and gas industry because of the large number of dollars involved and is an issue which should to be decided by this Court.

CONCLUSION

For these reasons, the Petition for Certiorari should be granted.

April 25, 1989

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APPENDIX TO
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PUBLISH

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

H.J. FREEDE; JOSEPHINE W. FREEDE; ROGER S. FOLSOM; and MARY M. FOLSOM, Petitioners-Appellees,	)	Nos. 86-2401, 86-2403 (Filed November 1, 1988)
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.	)	

ON APPEALS FROM THE DECISIONS OF
THE UNITED STATES TAX COURT
(T.C. Nos. 16339-82, 20768-82)

Bruce R. Ellisen (Roger M. Olsen, Assistant Attorney General; Michael L. Paup; and Ann Belanger Durney, with him on the briefs), Tax Division, Department of Justice, Washington, D.C., for Respondent-Appellant.

Terry R. Hanna of Crowe & Dunlevy (Donald R. Lisle and Charles N. Woodward of Lisle & Woodward, Oklahoma City, Oklahoma, with him on the brief), Oklahoma City, Oklahoma, for Petitioners-Appellees.

Before MOORE, BARRETT, and EBEL, Circuit Judges.

EBEL, Circuit Judge.

H.J. and Josephine Freede and Roger and Mary Folsom ("Taxpayers") petitioned the United States Tax Court for redetermination of alleged deficiencies in taxes for the 1979 tax year.[1] The deficiencies relate to certain excess payments they received from Oklahoma Gas & Electric Company ("OG&E") under a "take or pay" provision in gas supply contracts for gas not taken by OG&E during the year in question. A divided Tax Court held in favor of Taxpayers, finding that the excess payments created "production payments" within the meaning of Section 636(a) of the Internal Revenue Code, 26 U.S.C. § 636(a), and Treas. Reg. § 1.636-3(a), 26 C.F.R. § 1.636-3(a), and therefore should be treated as nontaxable loans with income recognized only when the gas is actually delivered. *Freede v. Commissioner*, 86 T.C. 340 (1986). The Commissioner has appealed, arguing that the excess payments did not create production payments and should be included as income for the year received pursuant to I.R.C. §§ 61(a) & 451(a).[2] We agree with the Commissioner because the excess payments did not give OG&E an economic interest in the gas in place. Accordingly, we reverse.

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[1] Josephine Freede and Mary Folsom are parties solely because they file joint returns with their husbands.

[2] I.R.C. § 61(a), 26 U.S.C. § 61(a), provides that gross income includes "all income from whatever source derived." I.R.C. § 451(a), 26 U.S.C. § 451(a), provides:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

I.

Taxpayers own fractional working interests in various oil and gas leases in Oklahoma. In 1975 and 1976, they entered into "take or pay" gas purchase contracts with OG&E.[3] Under these contracts, OG&E agreed to pay for a specified minimum quantity of gas each year, regardless of whether it took physical delivery of the gas. If the amount of gas paid for under the "take or pay" provision exceeded the amount of gas actually taken from Taxpayers' wells, OG&E had the right to credit the excess amount in later years against gas taken in excess of the minimum contract quantity.[4] However, OG&E would lose the benefit from any excess payments that it did not recoup by taking extra gas within the twenty-year term of the contracts.

In 1979, OG&E made the minimum payment required by the contracts but took less than the minimum contract quantity. Thus, a portion of the contractual payments that

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[3] Although Taxpayers did not appear on the contracts as parties, they were bound by them and performed and received performance as a seller under the terms of the contracts. The contracts are virtually identical and will be referred to collectively.

[4] The contract specifically provides:

> If Buyer shall be required to pay for any gas not taken and received during any contract year, Buyer shall have the right to make up such deficient gas volumes by crediting the volumes of gas so paid for and not taken against such gas as may be taken during any subsequent contract year during the term hereof in excess of the applicable minimum contract quantity for such year. Such gas shall be taken at no additional cost to Buyer.

Taxpayers received from OG&E in 1979 represented payment for gas not actually taken in that year. At that time, the leases had sufficient projected reserves to enable OG&E to recoup the untaken gas in later years if it wanted to do so.

Although Taxpayers were on the cash, as opposed to accrual, method of accounting, they did not include as income the amounts received in 1979 for gas not taken that year. They maintained, and the Tax Court agreed, that OG&E's excess payments created "production payments" pursuant to I.R.C. § 636(a), 26 U.S.C. § 636(a), and therefore the payments should be treated for income tax purposes as if they were loans, with income recognized only when the gas is actually delivered in subsequent years.[5] We disagree.

II.

In order for OG&E's right of recoupment to constitute a production payment under Section 636(a), several criteria must be satisfied: (1) OG&E must have a right to a specified share of gas production or the proceeds from such production; (2) the right must have a specified economic life (at the time of its creation) of less than the economic life of the mineral property which it burdens; (3) the right must be an economic interest in the mineral

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[5] Section 636(a) provides in pertinent part:

> A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property.

in place; (4) the right cannot be satisfied by other than the production of gas from the burdened mineral property; and (5) the right must be limited by either a dollar amount, a quantum of mineral, or a period of time. *See* Treas. Reg. § 1.636-3(a)(1).[6] On appeal, the Commissioner challenges the Tax Court's conclusion with respect to just one of these criteria – that OG&E's recoupment right constituted an "economic interest" in the minerals in place.

A test for determining the existence of an "economic interest" in minerals in place has been derived from

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[6] The regulation, 26 C.F.R. § 1.636-3(a)(1), provides:

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in the mineral in place. It may burden more than one mineral property, and the burdened property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments."

Palmer v. Bender, 287 U.S. 551 (1933). In that case, the taxpayers had transferred their operating rights in certain oil and gas leases to oil companies in exchange for bonus payments and a right to royalties from the oil produced and saved. They sought to claim depletion on the revenue received. The Tax Commissioner argued that the taxpayers were not entitled to a depletion allowance because the taxpayers had, in effect, sold the leases. In rejecting the Commissioner's argument, the Court held that an economic interest did not depend upon legal title to the mineral. *Id.* at 557. Instead, the Court focused on the taxpayers' investment in the oil in place:

> [The depletion statute covers] every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

Id. Under that analysis, the Court found that the taxpayers there had "retained, by their stipulations for royalties, an economic interest in the oil, in place." *Id.* at 558. The Court explained that the taxpayers' investment and their economic risk were directly connected with the production of the oil in place:

> Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the [taxpayers].

Id.

Subsequent courts have characterized *Palmer* as establishing a two-part test for determining whether

there is an economic interest: (1) there must be an interest, acquired by capital investment, in the minerals in place; and (2) the return on the investment must be realized solely from the extraction of the minerals. *See Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 314 (1956); *Rissler & McMurry Co. v. United States*, 480 F.2d 684, 686 (10th Cir. 1973).[7]

Applying the *Palmer* test to this case, we conclude that OG&E's recoupment rights under the "take or pay" contracts do not give rise to an economic interest in the gas in place sufficient to amount to a production payment for Section 636(a) purposes.[8]

A. *Does OG&E Have an Interest in the Minerals in Place?*

In order for OG&E's recoupment right to satisfy the first prong of the *Palmer* test, OG&E must have an interest in the gas in place. Whether there is an "interest" in minerals in place depends upon an evaluation of various factors, including: (1) the degree of legal interest in the minerals; (2) whether there is significant control over the mineral deposits; (3) the extent of contribution to the

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[7] Most cases analyzing the meaning of "economic interest" have arisen in the depletion context. Nevertheless, the economic interest concept also has been applied to decide whether a transaction is a sale or a lease in capital gains cases, *see United States v. White*, 401 F.2d 610, 613 (10th Cir. 1968) (en banc), and is now one of the requirements for special tax treatment of production payments. *See* Treas. Reg. § 1.636-3(a)(1).

[8] We address only whether a 636(a) production payment was generated by the excess payments made under these "take or pay" provisions, and we do not address other ways in which production payments may be generated.

development or operation of the mineral extraction; (4) risk of loss; and (5) whether the interest is necessarily depleted as the mineral is extracted. *See, e.g., Tidewater Oil Co. v. United States*, 339 F.2d 633, 637 (Ct. Cl. 1964) (discusses legal interest, control, and extent of contribution as factors), *citing* Sneed, *The Economic Interest – An Expanding Concept*, 35 Texas L. Rev. 307, 355 (1957); *Marathon Oil Co. v. Commissioner*, 838 F.2d 1114, 1125 (10th Cir. 1987) (discusses risk as a factor); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946) (discusses depletion as a factor). None of these factors is a *sine qua non* for satisfying the first prong of the *Palmer* test. Instead, they all should be considered in reaching an overall determination of whether an interest in the minerals in place has been created. In reviewing the five factors, we find that OG&E's recoupment right satisfies two of them.

As for the first factor, OG&E has no legal title or leasehold interest in the gas or the gas-producing property. In fact, the contracts state specifically that title to the gas passes from seller to buyer at the point of delivery, which occurs at the wellhead or at the outlet of the well separator, if any. Although the absence of title is not determinative, *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946), it is telling that the Supreme Court has found an economic interest in only one case where a fee or leasehold interest in the mineral property was lacking, *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956).

In *Southwest*, owners of uplands adjacent to certain offshore oil deposits contracted with a drilling company to allow the company to use their lands for whipstock drilling to reach the oil in return for a share of the

company's profits. The Court held that the upland owners were entitled to a depletion allowance on the amounts received because they had a sufficient "economic interest" in the oil deposits. The Court based this conclusion on the fact that the use of the uplands was essential to the drilling operations because of the proximity of the lands to the deposits and because state law allowed offshore oil deposits to be reached only from drilling on these uplands. Thus, the *third* factor noted above – contribution to the development or operation of the mineral extraction – was prominently met in *Southwest*. The Court was careful to limit its holding to those facts:

> We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an *indispensable* contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

Id. at 317 (emphasis added).

Unlike the upland owners in *Southwest*, OG&E has not met the third factor by contributing to production of the gas or operation of the gas wells. OG&E certainly provided no property or interest that necessarily contributed to production. Instead, its role essentially was one of a customer or buyer of the gas rather than as a producer of the gas. *See* Part II.B below.

With regard to the second factor, we conclude that OG&E does appear to have significant control over the minerals although, as we show later, its control is in the

nature of a buyer's contractual rights rather than as a producer of the gas. The Tax Court based its conclusion that OG&E had an economic interest largely on its finding that OG&E had the contractual power to control production. *Freede*, 86 T.C. at 350. The court noted that OG&E could require the sellers to maintain "deliverability" at 125% of the minimum daily contract quantity and could compel the sellers to deliver gas into the pipeline at the "maximum rate" of production that, in the seller's sole judgment, would not damage the wells or decrease ultimate recovery.[9]

On the other hand, our reading of the contracts reveals that there are a number of important limitations on OG&E's powers over production. First, as Taxpayers concede, the sellers' agreements to maintain deliverability of gas equal to 125% of the daily contract quantity is, under the definitions set forth in the contracts, merely an obligation to maintain deliverability of 100% of what the seller chooses to "ma[k]e available" to the buyer.[10] Thus, this provision by itself does not give

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[9] "Deliverability" is contractually defined as "the volume of gas attributable to Seller's gas reserves actually delivered to Buyer at the point of delivery against the required delivery pressure during the twenty-four hour period following delivery of gas at the maximum rate of flow from Seller's well against the required delivery pressure for a period of three (3) days." The contract also provides that "[e]ither party hereto may request a determination of such deliverability upon giving the other party at least ten (10) days notice prior to the commencement of such test."

[10] This is true because the seller has some control over the minimum contract quantity. The minimum average daily

(Continued on following page)

OG&E control over the amount of production. Rather, the *seller* has control over this amount in the first instance.

Second, although the contract does allow OG&E to compel production at the "maximum rate at which said wells are capable of producing," this is only an "all or nothing" type of control. Moreover, the seller has the right to determine the maximum rate such that production will not damage the wells and will not decrease the ultimate amount of gas which can be recovered from the wells.[11] The contracts also allow the sellers to abandon wells if they determine that the wells are not capable of producing gas in paying quantities. In addition, the seller has the right to sell the gas to others to protect its reservoir against unequal drainage if OG&E is not able to take delivery of sufficient gas to prevent unequal drainage.

Although OG&E certainly does not have unfettered control, we conclude under the contracts before us that OG&E at least possesses "significant" control.

(Continued from previous page)

contract quantity is defined in the contract as the *lesser* of 80% of deliverability against the required delivery pressure *or* 80% of the volume of gas *made available* by the seller to the buyer.

[11] Although the contract leaves this determination to the seller's "sole judgment," it is likely that an implied requirement of reasonableness or good faith would limit the seller's power. *See, e.g., Garr-Woolley v. Martin*, 579 P.2d 206 (Okla. App. 1978) (right under terms of oil and gas lease to remove all fixtures and machinery "at any time" construed as meaning "within a reasonable time"); 12A Okla. Stat. Ann. § 1-203 (good faith requirement under UCC). *See also Big Horn Coal Co. v. Commonwealth Edison Co.*, 852 F.2d 1259, 1267 (10th Cir. 1988).

The third factor concerning contribution to the development of the well is not met here, as discussed above.

The fourth factor – risk of loss – is satisfied here. Risk of loss often has been used as an indicia of an ownership interest. *See, e.g., Marathon Oil Co. v. Commissioner*, 838 F.2d 1114, 1125 (10th Cir. 1987); *Christie v. United States*, 436 F.2d 1216, 1221 (5th Cir. 1971). Here, we conclude that OG&E does bear a risk of losing its recoupment rights if anything were to happen to the property covered by the contracts such that production became inadequate to enable OG&E to recover its recoupment interest over and above the required minimum contract quantities. OG&E has no place to look for recovery of its recoupment interest except to production from the property.

The fifth factor, concerning whether OG&E's recoupment interest in the gas is "necessarily reduced" as production occurs, is not met here. That factor is typically used to determine an "economic interest" in the depletion context. *See Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946); *Weaver v. Commissioner*, 72 T.C. 594, 600 (1979). OG&E fails to meet this factor because it has been stipulated that reserves exceed OG&E's right to take production, and hence the operator can produce gas from the well without "necessarily" reducing OG&E's recoupment interest. In fact, only if OG&E takes more than the minimum quantity in a given year and elects to use the excess to reduce its right of recoupment will its recoupment interest be diminished by production. Thus, it is possible that up to 20 years of production (the term of the contract) could pass without reducing the recoupment interest.

A consideration of the above factors does not lead us to any clear conclusion as to whether OG&E has an interest in the gas in place under the first prong of the *Palmer* test. A resolution of that issue would require an analysis of the weights to be given to the various factors upon the facts before us. Because we conclude, however, that OG&E's recoupment rights clearly fail the *second* prong of the *Palmer* test, we need not conduct such an analysis.

B. *Does OG&E Look to Income Derived Solely From Extraction of the Mineral for Return of Its Investment?*

OG&E's recoupment right fails to meet the *second* prong of the *Palmer* test because OG&E has not made any investment in the gas-producing enterprise and certainly does not look to income derived solely from extraction of the mineral for the return of any investment. The economic reality is that OG&E's interest is merely that of a consumer paying for gas it receives at the wellhead, not an investor looking for profit from successful extraction. In other words, OG&E's interest is an "economic advantage" rather than an "economic interest" in the minerals in place.

This distinction was first set forth in *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938), in which the Supreme Court differentiated between contractual advantages and capital investments:

> [T]he phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit.

Id. at 367.[12] In that case the Court held that a processor who had the contractual right to take wet gas from the wellheads and to extract and sell the gasoline therefrom, paying the well owners a share of the proceeds from the sales, had not acquired an economic interest in the gas in place but only an economic advantage. The Court stated that "apart from its contracts with producers, respondent had no interest in the producing wells or in the wet gas in place. Respondent is a processor. It was not engaged in production." *Id.* at 367.

We find that *Bankline* compels reversal here. Like the oil company in *Bankline*, OG&E has contractual rights to take delivery of gas at the wellhead for processing and future sale, but OG&E is not involved in the production of the gas and does not have any legal interest in the wells. Nor are OG&E's excess payments properly viewed as investments in the gas property. They are more like pre-determined damages payable to the producer for gas that was not taken as expected. The fact that those payments are not irretrievably lost but can be recouped by the purchaser out of excess production in later years does not convert them into an investment. Thus, OG&E's recoupment right entitles OG&E to a mere economic advantage and does not constitute an economic interest in the minerals in place. *See also Parsons v. Smith*, 359 U.S.

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[12] Treas. Reg. § 1.611-1(b)(1) contains a similar distinction between an economic interest and an economic advantage. It provides that "[a] person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production."

215, 224-26 (1958); *Rissler & McMurry Co. v. United States*, 480 F.2d 684, 687 (10th Cir. 1973).

Furthermore, OG&E is not seeking, through its recoupment right, a profit from the *extraction* of gas. One indication of an economic interest is the "possibility of profit" that is "dependent solely on the extraction and sale" of the mineral. *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 34-35 (1946); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 604 (1946).[13] OG&E, however, is not an investor seeking profit from gas production. Its excess payments do not entitle it to anything more than an amount of gas in subsequent years equivalent to that paid for but not taken in earlier years. If OG&E recovers its recoupment gas in later years it will merely be taking late delivery of gas that it paid for earlier at the price agreed to by the parties. If it does not recover recoupment gas before the expiration of its contract, it will suffer a loss, not a profit. The "take or pay" obligation merely made OG&E a more attractive customer to the Taxpayers, not an investor in the property. OG&E's profit is derived solely from the remarketing of the gas to its customers downstream from production, and not from production itself.[14]

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[13] *See also S.E.C. v. Howey Co.*, 328 U.S. 293, 298-99 (1946) (defining "investment contract" in the securities context as a "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

[14] Additional evidence of OG&E's consumer status are contractual provisions which give it the ability to reject and refuse to pay for gas that does not meet quality specifications.

We conclude that OG&E's recoupment rights do not amount to an "economic interest" in the minerals in place because they do not satisfy the second prong of the *Palmer* test. Therefore, we hold that OG&E's excess payments did not create production payments for Section 636(a) purposes and thus should be included in Taxpayers' income in the year received.

REVERSED.

January 27, 1989

Before Honorable James E. Barrett, Honorable Monroe G. McKay, Honorable James K. Logan, Honorable Stephanie K. Seymour, Honorable John P. Moore, Honorable Stephen H. Anderson, Honorable Deanell R. Tacha, Honorable Bobby R. Baldock, Honorable Wade Brorby and Honorable David M. Ebel, Circuit Judges

H.J. FREEDE; JOSEPHINE W. FREEDE; ROGER S. FOLSOM; and MARY M. FOLSOM, Petitioners-Appellees,	)	Nos. 86-2401, 86-2403
vs.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.	)	

The court's opinion was filed in the captioned cases on November 1, 1988. The panel judges, upon their own motion, hereby revise that opinion by amending the second sentence of the last paragraph on page 14 to read:

> One indication of an economic interest is the "possibility of profit" that is "dependent solely on the extraction and sale" of the mineral.

The court also has for consideration appellee's petition for rehearing and suggestion for rehearing en banc.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision sought to be reheard.

In accordance with Rule 35(b) of the Federal Rules of Appellate Procedure, the petition for rehearing and suggestion for rehearing en banc were transmitted to all the judges of the court in regular active service. No member of the hearing panel and no judge in regular active service on the court having requested that the court be polled on hearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

Judge Holloway did not participate in consideration or disposition of the suggestion for rehearing en banc.

ROBERT L. HOECKER, Clerk

86 T. C. No. 22

UNITED STATES TAX COURT

H. J. FREEDE and JOSEPHINE W. FREEDE, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

ROGER S. FOLSOM and MARY M. FOLSOM, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 16339-82, 20768-82. Filed March 11, 1986.

Petitioners, as owners of fractions of the working interests in an oil and gas lease, were subject to contracts for the sale of natural gas to OG & E for 20 years. The contracts obligated OG & E to take or pay for a minimum of 80 percent of the deliverable gas from the leases. If the amounts paid exceeded the value of the gas actually delivered, OG & E was entitled to gas actually produced in the later years equal to the excess without additional payment. In 1979, the payments by OG & E exceeded the value of gas actually delivered. The projected reserves were adequate to supply OG & E with gas which was paid for but not received in 1979.

Held, the payments for gas not taken by OG & E create a production payment within the meaning of sec. 636(a), I.R.C. 1954, and sec. 1.636-3(a), Income Tax Regs. The payments, therefore, from OG & E to petitioners in 1979 are characterized under sec. 636(a), I.R.C. 1954, as nontaxable loans.

Terry R. Hanna, for the petitioners in docket No. 16339-82.

Donald R. Lisle, for the petitioners in docket No. 20768-82.

Osmun R. Latrobe, for the respondent.

OPINION

GOFFE, *Judge:* The Commissioner determined the following deficiencies in petitioners' Federal income taxes for the taxable years 1978 and 1979:

Petitioner	*Taxable Year*	*Deficiency*
H.J. and Josephine W. Freede	1978	$105,758.53
	1979	551,348.33
Roger S. and Mary M. Folsom	1978	8,056.00
	1979	97,444.00

The two cases, docket Nos. 16339-82 and 20768-82, were consolidated for trial, briefing, and opinion. The parties have settled numerous adjustments determined by the Commissioner in the statutory notices of deficiency. The sole issue for decision is whether petitioners are required to include in taxable income for the taxable year 1979 amounts received from Oklahoma Gas and Electric (hereinafter referred to as OG & E) pursuant to a "take or pay" Gas Purchase Contract.

All of the facts have been stipulated and the consolidated case was submitted to this Court without trial pursuant to Rule 122.[1] The stipulations of facts and accompanying exhibits are so found and incorporated by reference.

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[1] All rule references are to this Court's Rules of Practice and Procedure. All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

At the time of filing the petitions in this case, H. J. and Josephine W. Freede, husband and wife, and Roger S. and Mary M. Folsom, husband and wife, resided in Oklahoma City, Oklahoma. Petitioners H. J. and Josephine W. Freede filed timely joint Federal income tax returns for the taxable years 1978 and 1979 with the Internal Revenue Service Center in Austin, Texas. Petitioners Roger S. and Mary M. Folsom filed timely joint Federal tax returns for the taxable years 1978 and 1979 with the Internal Revenue Service Center in Austin, Texas. Josephine W. Freede and Mary M. Folsom are parties in this case solely because they filed joint returns with their husbands. H. J. Freede (Freede) and Roger S. Folsom (Folsom) will be referred to jointly as petitioners.

During the taxable years at issue, petitioners were each, in addition to their other income producing activities, in the business of producing oil and gas. They carried out their business by purchasing fractional working interests in various mineral leases, which were then developed and operated by others. They each had adopted and used the cash receipts and disbursements method of accounting.

During the taxable years at issue, Freede and Folsom held working interests in Endicott No. 1 lease in Blaine County, Oklahoma, of .04362 percent and .013672 percent, respectively. The production from the lease consisted principally of natural gas.

On or about October 28, 1975, a Gas Purchase Contract for the production of natural gas from the Endicott No. 1 lease was entered into between OG & E as purchaser and An-Son Corporation as seller. On or about

January 14, 1976, a Gas Purchase Contract for the production of natural gas from the Endicott No. 1 lease was entered into between OG & E as purchaser and A. Ben Chadwell and Julie Racz as seller. Although neither Folsom nor Freede appeared on either contract as parties, both petitioners were bound by, performed, and received performance as sellers under the terms of the contracts. The terms of both contracts are virtually identical, with the exception of slight differences such as the local base prices. All references to the contracts, purchaser, or seller for the remainder of this opinion refer to both contracts and the parties to both contracts, collectively.

The primary terms of the contracts were for 20 years. All of the gas produced and saved from the lease, with minor reservations, was sold to the purchaser.[2] The contracts required that the seller make 100 percent of the deliverability[3] of each well covered by the lease available to the purchaser. The contracts also included a "take or pay" provision which required the purchaser to pay for

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[2] The price paid was set with reference to a local base price, escalating one cent per thousand cubic feet each year thereafter, subject to adjustments upwards or cancellation of the contract under certain circumstances.

[3] "Deliverability" is defined in the contracts as the volume of gas attributable to Seller's gas reserves actually delivered to Buyer at the point of delivery against the required delivery pressure during the 24-hour period following delivery of gas at the maximum rate of flow from Seller's wells against the required delivery pressure for a period of 3 days. For convenience that term will be used in this opinion although, in general terms, it could describe "production" from the wells.

80 percent of the deliverability of each well covered by the lease, regardless of whether the purchaser took physical delivery of any gas at all.[4] The amount of gas or substituted payment under the "take or pay" obligation was also referred to as the minimum contract quantity. The seller was obligated to maintain deliverability of 125 percent of the minimum contract quantity.

Under the contracts, if the amounts paid in any taxable year exceeded the amounts attributable to the gas actually taken, OG & E was entitled to an offset for the excess payments in subsequent years to the extent that the gas taken in later years exceeded the minimum contract quantity. Thus the purchaser was not obligated to pay for the gas taken in future years until the value of the gas taken exceeded both the minimum contract quantity payments for that year and the excess payments made in earlier years. So long as the purchaser continued to make minimum payments, the contracts did not require that the purchaser take even a minimum of gas in any particular year. If the payments exceeded the value of the gas taken, however, the purchaser's only right of recoupment was from the production of gas in excess of the minimum contract quantities in future years. The purchaser's right of recoupment or recovery was protected, however, by the fact that OG & E could require that the seller produce

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[4] The "take or pay" obligation was reduced in the event that the seller was unable to maintain normal deliverability. In that case, the purchaser was required only to take or pay for 80 percent of the production actually made available to the purchaser.

gas in an amount equal to 100 percent of the deliverability of each well covered by the lease, or 25 percent in excess of the minimum contractual amounts.

Pursuant to the contracts, the purchaser made the minimum payments to the seller in the taxable year 1979 calculated with reference to 80 percent of the deliverability of each well covered by the lease, as set forth by the contracts. A portion of the payment was for gas actually taken under the contracts. As the amount of gas taken was not equal to or more than the minimum contract quantity, a portion of the minimum contract amount paid under the terms of the contracts was for the difference between the gas taken and the minimum contract quantity of gas. Under the terms of the contracts, OG & E was, therefore, not obligated to pay for gas taken in subsequent years in excess of the minimum contract rate until the amounts paid in 1979 were offset by the additional gas taken. In 1979, the lease had sufficient projected reserves to repay OG & E in gas, prior to the expiration of the contracts, for the contractual minimum payments paid for gas not taken.

As owners of portions of the working interest, Freede and Folsom received payments from OG & E in the taxable year 1979 in the respective amounts of $462,881.30 and $205,963.44. The amounts received represented both payments for gas actually taken by OG & E and payments for the difference between the amount OG & E was contractually obligated to pay for and the volume of gas actually taken. The respective amounts are as follows:

Type of Payment	*Freede*	*Folsom*
Payments for gas taken	$119,626.14	$ 64,802.26
Payment for the difference between minimum contractual payment and payment made for gas taken	343,255.16	141,161.18
Total payments to petitioners	$462,881.30	$205,963.44

The amounts representing payments for gas actually taken by OG & E were included as income by petitioners on their respective Federal income tax returns for the taxable year 1979. The payments made pursuant to the contractual minimum that represented advance payments for gas not taken were not included by either petitioner as income for the taxable year 1979. Both petitioners decided to include in income for later taxable years payments for gas taken by OG & E during those years in excess of the minimum contract quantity.

Petitioners contend that the advance payments received under the "take or pay" contracts with OG & E create an economic interest entitling OG & E to production payments under section 636(a). If the advance payments are an investment in future production, the minimum contract payments paid for gas not taken in 1979 would be treated as loans from OG & E to petitioners, with income recognized only when the gas is actually delivered in subsequent years. Respondent contends that the entire amounts received from OG & E constitute realized income which should be recognized

under section 61(a) and section 451,[5] citing Rev. Rul. 80-48, 1980-1 C.B. 99.

A production payment, in general terms, is a right to minerals in place that entitles its owner to a specified share of production for a limited time from a specified mineral property when production occurs. Sec. 1.636-3(a)(1), Income Tax Regs.; see H. Rept. 91-413 (1969), 1969-3 C.B. 200; S. Rept. 91-552 (1969), 1969-3 C.B. 423; F. Burke & R. Bowhay, Income Taxation of Natural Resources, par. 2.07, at 206 (1985). A "carved-out" production payment arises where the owner of an interest in a mineral property assigns a production payment to another person but retains his interest in the property from which the production payment is assigned. If such a production payment is created, section 636(a) describes the tax consequences:

> (a) Carved-out Production Payment. – A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. * * *

It is important to the discussion which follows to point out that although section 636(a) and the regulations

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[5] Sec. 61(a) provides that gross income includes all income from whatever source derived. Sec. 451 provides that:

> The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

thereunder require that the production payment be an actual economic interest, the transaction nevertheless is treated as a loan for Federal income tax purposes.

Sections 1.636-3(a)(1) and (2), Income Tax Regs., further define the term "production payment":

> (a) *Production payment.* (1) The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments".
>
> (2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an

> operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. * * *

Section 1.636-1(a)(1)(ii), Income Tax Regs., prescribes the tax consequences as follows:

> The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and "gross income from the property" (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not "gross income from property") amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deduction as if such production payment were a loan. * * *

The treatment of the advance payments and the resultant tax consequences depend upon whether or not such payments are an investment in future production that create a production payment constituting an economic interest under sections 611 and 636. Applying the Code and regulations to this case, the question is whether the advance payments from OG & E to petitioners which create a right in OG & E to share in the future production of gas are, under section 636(a), treated as production payments. If so, then the payments to petitioners by OG & E would be characterized under section 636(a) as loans from OG & E to petitioners which would not be taxable income to petitioners in the year before the Court.

The criteria that must be satisfied under the terms of the statutes and regulations set forth above are: (1) the purchaser must have a right to a specified share of production or the proceeds from such production; (2) the interest must have an expected economic life (at the time of its creation) of shorter duration than the economic life of the mineral property upon which it is a burden; (3) the right must be an economic interest in the mineral in place; (4) the interest must not be able to be satisfied by other than the production of mineral from the burdened mineral property; and (5) the production payment must be limited by either a dollar amount, a quantum of mineral, or a period of time. In this case, each of the criteria has been met.

The contracts provide that the purchaser is entitled to the entire production of the lease, and is required to take or pay for 80 percent of the deliverability of each well covered by the lease. The sellers agreed to maintain deliverability and production of each well at 100 percent, which is 125 percent of the minimum contract quantity. OG & E clearly has the right to a specified share of the production from the lease, thus satisfying the first criterion.

The second criterion has also been met in that OG & E can recoup the amounts paid for gas not received from the projected reserves prior to the termination of the contracts. The economic life of the interest created by the advance payments is thus limited to the terms of the contracts, which are shorter than the economic life of the property.

The third criterion, however, is the principal point upon which the parties disagree. In order for the advance payments to be treated as an investment in future production by OG & E rather than as income to petitioners, payments made pursuant to the contracts must create a depletable economic interest as defined in section 1.611-1(b)(1), Income Tax Regs.:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for the return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. * * *

Petitioners contend that OG & E acquired an economic interest in the gas in place by virtue of the rights and obligations under the "take or pay" contracts. Respondent argues the converse, proposing that OG & E had merely a contractual right to receive the gas, not a property interest in the gas itself; OG & E had at best an "economic advantage," not an "economic interest."

Although section 1.611-1(b), Income Tax Regs., purports to adequately define the term "economic interest," a

number of cases have expanded upon the vague meaning of the term. Even the courts, however, have found it difficult to single out one recurring factor that clearly indicates ownership of an economic interest in the minerals in place. *Tidewater Oil Co. v. United States*, 168 Ct. Cl. 457, 339 F.2d 633 (1964).

The purchaser need not have legal title to the property to have an economic interest,

> [i]t is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. * * * [*Palmer v. Bender*, 287 U.S. 551, 557 (1933).]

A taxpayer has an "economic interest" in minerals regardless of the legal form of the interest if he has acquired the interest by investment in the minerals in place, and looks to the extraction of the minerals for the return of his investment. *Gulf Oil Corp. v. Commissioner*, 86 T.C. ___ (Jan. 30, 1986); *Husky Oil Co. v. Commissioner*, 83 T.C. 717, 739-741 (1984), on appeal (10th Cir. Oct. 24, 1985); *Thomas v. Perkins*, 301 U.S. 655, 661 (1937).

For an interest to be an economic interest within the terms of section 636(a), the payments must be in exchange for the receipt of minerals and there must also be an investment in the production of the minerals. *Gibson Products Co. v. United States*, 637 F.2d 1041 (5th Cir. 1981); *Weaver v. Commissioner*, 72 T.C. 594 (1979). Thus, where the taxpayer was merely a processor of oil and was not engaged in production, the taxpayer had no interest in the mineral in place. The fact that the taxpayer obtained an economic advantage from the production of the gas was not adequate basis for the creation of an

economic interest. *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367-369 (1938). "The test * * * is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted." *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603 (1946). "Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." *Kirby Petroleum Co. v. Commissioner, supra* at 604; *Gulf Oil Corp. v. Commissioner, supra.*

Although the cases cited above repeatedly conclude that title is not required as a prerequisite to an economic interest, no taxpayer was found to possess an "economic interest" who did not also hold either a fee interest or a leasehold interest in the mineral property until *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956). The taxpayers were fee owners of upland adjoining property that the State of California required that the operator use for access, by means of slant drilling, to the offshore mineral properties. The taxpayers granted the operator the right to drill in exchange for a net profits interest, and subsequently claimed depletion on the amounts received. The Supreme Court held that the taxpayers, although neither owners of the fee interest nor lessors of the minerals had an "economic interest" upon which they were entitled to depletion. In so holding, the Court held:

> It is true that the exclusive right to drill was granted to Southwest, and it is also true that the agreements expressly create no interest in the oil in the upland owners. But the tax law deals in economic realities, not legal abstractions, and upon closer analysis it becomes clear that these factors do not preclude an economic interest in the upland owners. [350 U.S. at 315.]

Respondent contends that the facts of this case are indistinguishable from *Helvering v. Bankline Oil Co., supra.* In that case, the taxpayer was merely a processor of the mineral and possessed no other rights whatsoever with respect to the mineral in place. The Supreme Court found that Bankline was afforded only "economic advantage" by virtue of the contract, rather than an economic interest in the minerals in place. 303 U.S. at 367. Respondent argues that OG & E also has no more than an economic advantage derived from the mere processing of the minerals made available to it under the contracts. Respondent's conclusion is that OG & E cannot, therefore, satisfy the third requirement for a production payment under section 636 because an economic advantage is not equivalent to an economic interest.

Petitioners argue that OG & E's interest in the production of gas from the lease rises to the level of an economic interest, due to the contractual rights and obligations of OG & E. We agree with petitioners.

Under the contracts, OG & E has the obligation to take or pay for 80 percent of the deliverability of each well covered by the lease. OG & E, however, also has the right to require the producers to maintain production equal to 100 percent of the deliverability of each well, or an amount equal to 125 percent of the minimum contract quantity. If OG & E pays an amount in excess of the value of gas actually taken, it has the right to offset the payments against any amounts produced in subsequent years in excess of the applicable minimum contract quantity. OG & E, in essence, has both rights to the minerals in place and a means of controlling production. Although OG & E did not have legal title to the minerals, title is not

the controlling factor. *Kirby Petroleum Co. v. Commissioner, supra* at 604. When the rights and obligations of OG & E under the contracts are viewed in their entirety, they rise to the equivalent of an economic interest under the statute, regulations, and case law.

The fourth factor that must be satisfied under section 1.636-3(a)(1), Income Tax Regs., for the advance payments to be treated as creating a production payment is that the advance payments must be satisfied only from the production of mineral from the burdened property. Under the contracts, OG & E pays an amount each year equal to 80 percent of the deliverability of each well covered by the lease, whether or not it takes the minimum contract quantity of gas. The only method by which OG & E can obtain value for the payments made is to take an additional amount of gas over the minimum contract quantity in future years. Further, the sellers are required to produce the gas which will repay OG & E for the amounts previously paid. OG & E has no other source for repayment other than the future production of gas from the lease specified in the contracts. The fourth criterion has been satisfied.

The final criterion is that the production payment must be a specified share of production limited by either a dollar amount, a quantum of mineral, or a period of time. In this case, the contracts provide that the advance payments are the equivalent of advance payment for gas to be received later. In each year OG & E must take or pay for 80 percent of the deliverability of the wells. In years when OG & E takes gas that it has previously paid for, that deliverability must come from the remaining 20 percent of production. Only the excess production above that

amount can be used for recoupment of the advance payments. OG & E can, however, compel production of that final 20 percent of production, otherwise defined as 125 percent of the minimum contract quantity. The amount of gas delivered is limited by the maximum amount of deliverability that can be imposed by OG & E, and is further limited by the fact that the contracts have a 20-year term within which OG & E must, if at all, recoup the advance payments from production. The fifth criterion is also satisfied under the facts of this case, and the requirements for a production payment as set forth in the statute and regulations thereunder have been met.

Respondent's final argument, however, is that Rev. Rul. 80-48, 1980-1 C.B. 99, sets forth the proper approach toward "take or pay" gas contracts and that such contracts create no more than an economic advantage. Rev. Rul. 80-48, *supra*, describes a "take or pay" gas purchase contract similar to the factual situation here: Y purchases a specified amount of gas from the taxpayer each month, but pays whether or not Y chooses to take the entire monthly production. Any advance payments made by Y create a right to future excess production without additional payment. The authors of the ruling conclude that:

> An agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production does not convey a depletable economic interest in mineral in place.
>
> The taxpayer, in this case, entered into an agreement with Y under the terms of which Y must purchase each month, for the life of the contract, a specified amount of gas. However, Y need not take the gas. Under the provisions of section 1.611-1(b) of the regulations such an agreement does not convey a

> depletable economic interest in mineral in place. [1980-1 C.B. at 99-100.]

A revenue ruling is no more than a statement of the Commissioner's position, and is "not entitled to any particular weight." *Anselmo v. Commissioner*, 80 T.C. 872, 883 n. 13 (1983), affd. 757 F.2d 1208 (11th Cir. 1985). The Fifth Circuit has further described the value of a revenue ruling:

> A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on the Secretary or the courts. It does not have the effect of a regulation or a Treasury Decision. [*Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146-1147 (5th Cir. 1971).]

The support offered for the conclusion drawn in the revenue ruling is section 1.611-1(b), Income Tax Regs., which provides that an agreement for purchase upon production is not a conveyance of a depletable economic interest in mineral in place.[6] As pointed out above, however, the "take or pay" contracts at issue in this case are

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[6] This revenue ruling has been discussed and in some cases criticized in oil and gas taxation texts and periodicals. See 2 L. Fiske, Federal Taxation of Oil & Gas Transactions, sec. 8.12 (1983); 1 Energy Resources Tax Reports (CCH) pars. 651-653 (1983); F. Burke & R. Bowhay, Income Taxation of Natural Resources, par. 15.15, at 1518 (1985); A. Bruen & W. Taylor, Federal Income Taxation of Oil & Gas Investments, par. 8.07[6][a] (1983 and Supp. 1985); Emery, "Current Developments in Oil and Gas Taxation," 32d Ann. Inst. on Oil & Gas L. Taxation 335, 352-353 (1981); Haschke, Crump & Huggins, "Mineral Production Payments; Gas 'Take or Pay' Purchase

(Continued on following page)

not merely agreements to purchase if production occurs. OG & E has a right of recoupment for the advance payments limited solely to future production of minerals and may compel production to satisfy the recoupment rights created by the advance payments. In essence, the purchaser has acquired by investment (the advance payments) an interest in the gas in place, which may be satisfied solely from the minerals extracted, thus fulfilling the definition of an economic interest under section 1.611-1(b)(i), Income Tax Regs.

We hold that a production payment as defined by section 1.636-3(a), Income Tax Regs., has been created, and the payments received in 1979 in excess of payments for gas delivered, are not taxable in 1979.

Decisions will be entered under Rule 155.

Reviewed by the Court.

STERRETT, SIMPSON, CHABOT, PARKER, WHITAKER, HAMBLEN, COHEN, CLAPP, SWIFT, and WRIGHT, *JJ.*, agree with the majority opinion.

WILBUR, KORNER, SHIELDS, and GERBER, *JJ.*, did not participate in the consideration of this case.

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Contract," 28 Oil & Gas Tax Quarterly 564 (1981); Burke & Karpen, "New Revenue Ruling 80-48: A Blueprint for Recreating Carved-out Production Payments?" 53 J. Taxation 370 (1980).

NIMS, *J.*, dissenting: I respectfully dissent, since I cannot agree that OG & E obtained a depletable economic interest in minerals in place as required by the regulations. Section 1.636-1(a)(1)(i); section 1.611-1(b), Income Tax Regs. Unless this paramount condition is met there is no production payment to which section 636(a) can apply.

A paradigm form of production payment is illustrated by the facts in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). The Supreme Court summarized the facts as follows:

> Lake is a corporation engaged in the business of producing oil and gas. It has a seven-eighths working interest in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000 and in consideration of his cancellation of the debt assigned him an oil payment right in the amount of $600,000, plus an amount equal to interest at 3 percent a year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer's working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years. [356 U.S. at 261-262].

The legislative history of section 636(a) (enacted in 1969) makes it clear that the section was a legislative response to certain perceived tax avoidance schemes following in the wake of *P.G. Lake*. See S. Rept. 91-552, 1969-3 C.B. 423, 538. For example, by certain maneuvering with production payments taxpayers were said to be able to avoid the 50 percent taxable income limitation for percentage depletion purposes, the foreign tax credit limitation, the 5-year net operating loss carryover limitation

and the seven-year investment credit limitation. Taxpayers were also seen as being able to amortize or pay off what was essentially a loan with before-tax dollars. 1969-3 C.B. at 539.

The Congressional response, as reflected in section 636(a), was to provide that production payment transactions in general are to be treated as loan transactions. I do not believe, however, that by taking this step to close one loophole Congress intended to open another. I agree that the form of a production payment transaction and that of a mortgage loan need not be precise analogues as the regulations themselves make clear.[1] Nevertheless, taxpayers must always make a threshold showing that the rights conveyed were a production payment; i.e., a depletable economic interest in minerals in place. I think petitioners have failed in their attempt to do so in this case.

As the regulations make clear, "an economic interest is possessed in every case in which the taxpayer [e.g., OG & E] has *acquired by investment* any interest in *mineral in place* * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he [OG & E] must look for a return of his capital." (Emphasis added.) Section 1.611-1(b)(1), Income Tax

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[1] Section 1.636-3(a)(2), Income Tax Regs., provides that "[a] right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest.)"

Regs.[2] By this definition, OG & E must have acquired the gas as an investment and be recovering its capital through sales to third parties. That is not, in fact what happened. It seems plain to me that OG & E is simply buying petitioners' gas at the wellhead, not mineral in place. OG & E then presumably transports the gas through its pipeline to its processing plant, for later sale to consumers.

I think this case is controlled by the Supreme Court's decision in *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). One of the contracts involved in *Bankline* provided for the purchase by the taxpayer from the producer of "all natural gas produced at a given well, the [taxpayer] paying 33-1/3 percent of the gross proceeds received by it from the sale of the gasoline extracted from such gas." The Supreme Court quoted with approval the government's representation that "under the contracts [taxpayer] took no part in the production of the * * * gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as a lessor or lessee, or as sublessor or sublessee, in any of the producing wells." 303 U.S. at 365. The purchaser [taxpayer] merely attached pipelines to the various wells and carried the gas from those wells to its processing plant where the gas was commingled with gas from other sources.

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[2] Section 1.611-1(b)(1), Income Tax Regs., has been characterized as having been drawn primarily from the opinions in *Palmer v. Bender*, 287 U.S. 551 (1933) and *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). See 1 B. Bittker, Federal Income Taxation of Income, Estates and Gifts, par. 24.1.2, p. 24-7 (1981 ed.).

The Supreme Court pointed out in *Bankline* that "[s]ome of the contracts, reciting that the producer was the owner of the gas produced, provided for its treatment [i.e., reduction of dry gas to gasoline] by [taxpayer]. Other contracts were couched in terms of purchase. In either case the gas was to be delivered to [taxpayer] at the casingheads or gas traps installed by the producer." 303 U.S. at 367-368.

The Court went on to say that "[t]he controlling fact is that [purchaser] had no interest in the gas in place. [Purchaser] had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance." 303 U.S. at 368.

I believe that OG & E is in exactly the same posture here as was the purchaser-taxpayer in *Bankline Oil Co.* The contracts in this case speak in terms of gas "sold and delivered" to OG & E. Section 2.2 provides that "[s]eller [petitioners] shall have the right to operate wells from which gas is produced * * * for delivery "into Buyer's pipeline [i.e., OG & E's pipeline.]" Article 5, entitled "Points of Delivery and Delivery Pressure," provides that the gas produced "shall be delivered at the wellhead of each well, or at the outlet of the well separator, if any. *Title to all gas sold hereunder shall pass from Seller to Buyer at said point of delivery.*" (Emphasis added.) There is absolutely nothing in either contract which says anything about OG & E making a capital investment in the gas in place. It follows, then, that this case simply does not involve production payments, and section 636(a) does not apply.

Section 61(a) provides that "gross income means all income from whatever source derived." Section 451 provides that "[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Under the facts of this case, the $484,416.34 received by petitioners in the years before the Court, and which the majority permits petitioners to defer for up to 20 years, should be included in petitioners' gross income in the years received, and I would so hold.

JACOBS, PARR, and WILLIAMS, *JJ.*, agree with this dissent.

PARR, *J.*, dissenting: In addition to the reasons articulated in the dissenting opinions of Judges Nims and Williams, in which I have joined, I dissent on an additional ground. What the majority has done here in holding that OG & E possesses an economic interest in the mineral in place extends the concept of "economic interest" much too broadly, and may provoke unforeseen consequences. This concept is fundamental in determining the tax consequences of transactions involving mineral properties. In particular, it is critical in determining who receives gross income from the property, who is entitled to depletion, and whether the disposition of an interest is a sale or a lease.

The majority's opinion has the result of elevating a prepaid contractual right to a supply of a mineral to the

level of an investment in the mineral in place, an economic interest. In this case, the majority's finding of an economic interest leads to the finding that a production payment exists, which is treated not as a depletable economic interest but as a loan, pursuant to section 636. It might be argued in this context that there has been no shifting of ordinary depletable income and thus little or no abuse in terms of tax dollars as a result of this decision, if both parties reported the transaction consistently.[1] However, in other contexts the finding that such a contractual right amounts to an economic interest may have a greater tax impact, such as entitlement to depletion deductions. Moreover, what the Court has done today is to mischaracterize a straightforward transaction, the tax consequences of which were clearly and correctly stated in Rev. Rul. 80-48, 1980-1 C.B. 99, and to open the door to the possible distortion of the tax consequences of all transactions involving natural resources.

NIMS, *J.*, agrees with this dissent.

WILLIAMS, *J.*, dissenting: The crux of this case is whether OG & E has an economic interest in the gas *in place*. I submit that it does not. At most, OG & E has secured for itself the economic advantage of a long term, stable supply of gas. As a consumer and not as an investor, it has prepaid for future deliveries to maintain both

[1] The record is silent with regard to OG & E's actual treatment of the payments. However, the majority opinion would preclude OG & E from deducting the payments to petitioners, and would require OG & E to report imputed interest on the amount treated as a loan. See sec. 1.636-1(a), Income Tax Regs.

that supply and its good relations with the supplier. OG & E has the right to command delivery to itself of any gas, *once extracted*, that meets certain specifications of the contract. In my view, that contractual right does not constitute an economic interest in the gas in place notwithstanding that OG & E might well take all of the gas extracted.

In *Palmer v. Bender*, 287 U.S. 551 (1933), the Supreme Court, faced with defining a depletable interest in minerals, stated as follows:

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, *by investment, any interest in the oil in place*, and secured, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. [Emphasis added] 287 U.S. at 557.

This language means that (a) the taxpayer must have a legal right to the mineral in the ground, (b) that right must be acquired by investment, and (c) a return of the taxpayer's investment must be realized out of income to be derived from extracting the mineral. See also, section 1.611-1(b)(1), Income Tax Regs.

In this case, OG & E has no legal right to the mineral in the ground; the contract provides that OG & E's legal ownership commences at the point of delivery (i.e., "the wellhead or the outlet of the well separator, if any "). OG & E has prepaid for a quantity of extracted gas that must be delivered to it in accordance with certain quality specifications and at a given pressure. Under the contract if the gas fails to meet quality specifications (e.g. maximum sulfur content), the parties will adjust the price or,

failing adequate adjustment, OG & E can exclude such gas from the contract. If the gas fails to meet the pressure specification, section 5.4 of the contract provides that unless either OG & E or the petitioners elect to install the equipment necessary to compress the gas to the acceptable pressure, " . . . the Buyer [OG & E] shall, on request of Seller [petitioners] release the production from any such well, together with the acreage attributable thereto, from the provisions of this agreement." It seems to me that in either circumstance (failure of quality or pressure), OG & E has no interest in the gas in place and no right to any income from the sale of such gas. Further, if production from the well is released, it is unclear whether OG & E can recover any prepayment for the gas or whether the sellers must make up deficient deliveries from other wells.[1] On this basis I believe that OG & E has not invested in this well, but has only prepaid for a commodity to be delivered to it. OG & E's right to the gas begins at the metering station on the pipeline and not in the well.

Furthermore, the price that OG & E pays for the gas is itself a strong indicator that OG & E has not invested in

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[1] The contract is silent. Bearing the risk of such loss (assuming that deficient deliveries are not made up as a business practice), however, can make economic sense. The economic advantage of a stable long-term supply may be worth losing the prepayment, e.g., where the cost of securing the supply on the spot market is higher than the price of long-term supply under the contract (including any forfeited prepayments). The record is apparently barren on this point, and I offer the observation only to counter any speculation that the prepayment must necessarily be an "investment" simply because OG & E in fact paid for gas in 1979 that was not delivered to it.

the gas well and does not look to its extraction to recover any "investment." The contract price for the gas is determined by reference to the market price paid by OG & E to other contract suppliers of gas of similar quality and pressure from similar formations and locations in identified counties. In general terms, this formula price can be said to reflect the local market price at the wellhead of a particular quality of gas at a given pressure. If the formula works as contemplated it should produce a price that is, within tolerable limits of deviation, the fair market value of such gas after extraction. OG & E is not, therefore, in a position to profit from any resale of this gas at the wellhead. Consequently, OG & E is not seeking a return from extracting the gas; rather, it is a consumer buying a supply of the commodity it consumes.

Finally, section 3.1 of the contract provides that the quantity of the gas to be delivered under the contract is the *lesser of* (a) 80% of the well's "deliverability" or (b) "80% of the volume of gas made available by Seller to Buyer." This provision seems to me to undercut the majority's view that "deliverability" and "production" are equivalent terms notwithstanding the seller's obligation under section 2.2 of the contract to operate the wells so that they " . . . will deliver gas into Buyer's pipeline when desired by Buyer at the maximum rate at which said wells are capable of production. . . ."

In summary, this agreement is nothing more than a long term supply contract that gives OG & E some assurance that a relatively stable source of natural gas can be delivered to its pipeline according to its specifications when its needs dictate.

NIMS, JACOBS, and PARR, JJ., agree with this dissent.